

**American Bar Association
Section Of Business Law**

**Panel Discussion: What The Business Lawyer Needs To
Know About The Environmental Issues Lurking Within
Sarbanes-Oxley And The Use of Environmental Management
Systems To Control Business Risk**

**THE USE OF ENVIRONMENTAL MANAGEMENT SYSTEMS
TO IDENTIFY AND MANAGE RISK**

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**I. THE USE OF ENVIRONMENTAL MANAGEMENT
SYSTEMS IS RAPIDLY EXPANDING**

- A. Principal purpose is to develop and implement a management system which can apply to a business operation of any size – local or global – to ensure achievement of environmental goals. This typically includes compliance with all applicable laws and regulations.
- B. The scope of the Environmental Management System (“EMS”) is frequently expanded to include health and safety matters, and occasionally transportation. It can also include company policies, sustainable development, corporate social responsibility and other desirable goals.
- C. The use of EMSes was substantially bolstered by the adoption by the International Organization for Standardization (“ISO”) in 1996 of the ISO 14001 “Environmental Management Systems – Specification with Guidance for Use”. This was developed through an international effort and has received worldwide acceptance and recognition.

D. What is an EMS? ISO 14001 defines an EMS as:

The part of the overall management system that includes organizational structure, planning activities, responsibilities, practices, procedures, processes and resources for developing, implementing, achieving, reviewing and maintaining the environmental policy. [Sec. 3.5]

E. Flexibility of ISO 14001:

Though it is identified as a “standard” it has many of the features of guidelines. Considerable flexibility is allowed in terms of how a company goes about adopting the required elements. Thus the Introduction states at p.vi:

It should be noted that this International Standard does not establish absolute requirements for environmental performance beyond commitment, in the policy, to compliance with applicable legislation and regulations and to continual improvement. Thus, two organizations carrying out similar activities but having different environmental performance may both comply with its requirements.

F. The 17 key elements of the ISO 14001 EMS:

1. Environmental policy – set by top management and effectively communicated throughout the company. Includes a commitment to compliance with environmental legislation and regulation and any other designated goals, and provides the framework for setting and reviewing environmental objectives. Must include commitment to continual improvement and pollution prevention.
2. Environmental aspects – a procedure for identifying all environmental impacts and aspects of the business, including any activities which are subject to environmental regulation.
3. Legal and other requirements – an ongoing procedure to identify all legal and other requirements applicable to all of the environmental

aspects and impacts, or other environmentally regulated activities, of the business.

4. Objectives and targets – set at each relevant function and level within the organization, consistent with the environmental policy, designed to achieve compliance, continuous improvement, and pollution prevention. Typically done annually.
5. Environmental management programs – specific programs designed to achieve the objectives and targets.
6. Structure and responsibility – assignment of roles and responsibilities to facilitate effective environmental management, including the provision of appropriate resources and accountability.
7. Training, awareness and competence – identification of training needs designed to ensure that all employees, contractors and other responsible personnel have the necessary knowledge, awareness and tools to properly carry out their responsibilities.
8. Communications – effective internal and external communication procedures regarding environmental matters.
9. Documentation – paper, electronic or both describing and implementing the EMS.
10. Document control – keeps documents current and available.
11. Operational controls – the actual controls over activities and operations which have the potential to impact the environment or are otherwise subject to environmental regulation. Includes contractor oversight.
12. Emergency preparedness and response.
13. Monitoring and measurement – including maintenance and calibration of monitoring equipment.

14. Non-conformance and corrective and preventive action – includes preventive and corrective action and maintenance, root cause analyses and action tracking systems.
 15. Records – including recordkeeping procedures.
 16. Auditing – includes auditing of the “system” as well as actual compliance with applicable environmental laws. Typically includes internal and external audits, and periodic self-assessments as needed.
 17. Management review – top management must review the EMS at appropriate intervals to ensure that it is functioning properly and is being adequately supported with appropriate resources. Any appropriate changes should be made. Typically periodic mid-level reviews are conducted as well.
- G. There are other templates and guidelines for EMSes as well. For example, EPA has issued guidelines for an enhanced EMS which places greater emphasis on assuring compliance with environmental law. See, EPA, *Compliance-Focused Environmental Management System – Enforcement Agreement Guidance*, Doc. No. EPA-330/9-97-002R (Rev. Aug. 2002).

II. EPA AND THE JUSTICE DEPARTMENT ENCOURAGE THE USE OF EMSes

- A. EPA and the Justice Department, as well as a number of state agencies, have stated that EMSes, when properly designed and implemented, are excellent tools to make management and other personnel at all levels in the organization aware of environmental requirements, and result in improved compliance.
- B. See, e.g., EPA, *EMS Position Statement* (May 15, 2002) on EPA website at www.epa.gov/ems; EPA, *Action Plan For Promoting the Use of Environmental Management Systems* (August 2, 2001) (EPA website, *supra*); EPA, *Code of Environmental Management Principles*, 61 Fed. Reg. 54062 (October 16, 1996). See also, Memorandum by John Peter Suarez, then EPA Assistant Administrator,

Office of Enforcement and Compliance Assurance, *Guidance on the Use of Environmental Management Systems in Enforcement Settlements as Injunctive Relief and Supplemental Environmental Projects* (June 12, 2003).

- C. See also, U.S. Department of Justice, *Factors in Decisions on Criminal Prosecution for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator* (July 1, 1991). This statement, as well as more recent Justice Department policy statements, indicates that a business organization with an effective EMS is less likely to be prosecuted criminally than a company which has no such program.
- D. EPA's support for a comprehensive and effectively implemented EMS, including an effective compliance auditing program, is also reflected in EPA's voluntary disclosure policy. EPA, *Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations*, 65 Fed. Reg. 19618 (April 11, 2000). See also, EPA's *Environmental Auditing Policy Statement*, 51 Fed. Reg. 25004 (July 9, 1986).

III. THE CAREMARK DECISION IN 1996 EMPHASIZED THE IMPORTANCE OF A MANAGEMENT SYSTEM WHICH ENSURES THE TIMELY FLOW OF CRITICAL INFORMATION CONCERNING BUSINESS RISK TO TOP MANAGEMENT AND THE BOARD OF DIRECTORS.

- A. *In re: Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) was a stockholders' derivative suit in which the court held that business management has a fiduciary duty to have in place an internal information reporting system which provides timely and accurate information to top management and the board of directors to allow those bodies each "to reach informed judgments concerning both the corporation's compliance with the law and its business performance." *Id.* at 970.
- B. The issue in *Caremark* was whether the directors followed adequate procedures to inform themselves regarding contracts with health care providers before authorizing the corporation to pursue contractual opportunities, so as to be protected under the "business judgment rule" from

claims of personal liability when impermissible contracts were entered into. The contracting processes included illegal “kickbacks”, and in 1994 Caremark was charged in an indictment with multiple felonies. It subsequently entered a plea agreement and paid civil and criminal penalties plus reimbursements to various private and public parties totaling approximately \$250 million. The 1996 case involved the court’s review and approval of the settlement of the shareholders’ suit against the company and its directors.

- C. The court specifically noted the duty to “assure corporate compliance with external legal requirements, including environmental . . . product safety . . . [and] other health and safety regulations.” *Id.* at 969.
- D. *Caremark* provides widely cited guidance on how business managers should design the flow of information inside the company to minimize the risks of significant business losses, such as occurred in that case.

IV. WHAT ARE THE ENVIRONMENTAL RISKS FACED BY BUSINESS ORGANIZATIONS?

- A. Non-compliance with federal, state or local environmental laws and regulations, including permitting and reporting requirements: typically civil penalties which run at the rate of \$25,000 per day of violation or more; criminal penalties which range from \$10,000 to \$50,000 per day of violation, and, depending on the seriousness of the offense, jail time for responsible corporate officers and employees. Civil liability involves “strict liability”. Some laws impose criminal liability for simple negligence. *See, e.g.*, the Clean Water Act, Section 309(c)(1), 33 U.S.C. § 1319(c)(1). Also administrative orders and injunctive relief.
- B. Site remediation costs, including removal and other response costs resulting from spills, improper discharges, leaks or other releases of waste materials.
- C. Response and clean up costs for off-site disposal which was either illegal or which has caused a release of hazardous substances, notably under the Comprehensive Environmental Response, Compensation and Liability Act

("CERCLA" or "Superfund"), 42 U.S.C. § 9601 *et. seq.* and corresponding state law.

- D. "Toxic Tort" liability to private parties for property damage or personal injury under common law theories of nuisance, negligence, trespass or strict liability for releases of toxic or hazardous substances off-site. Can also include injuries to personnel from exposures to toxic materials on site.
- E. Commercial Acquisitions. Exposure to any or all of the foregoing damages arising out of the improvident acquisition of commercial property, whether through an asset purchase or stock purchase, if the property turns out to be contaminated or subject to regulatory non-compliance penalties or other outstanding environmental liabilities.
- F. Compliance Costs. Substantial costs and expenditures for capital and operating equipment required to comply with environmental laws. These must be carefully estimated in advance.
- G. Reporting and Disclosure Requirements. As discussed elsewhere in this program, material anticipated costs of environmental compliance (including expenditures for the protection of health, safety and the environment), as well as anticipated penalties, litigation losses or other reasonably foreseeable costs associated with environmental claims or losses, must be disclosed in annual and quarterly reports, and registration statements, filed with the SEC. The importance of accurate certifications, and the penalties for the failure to make sure that the information provided is accurate, was significantly enhanced as a result of the Sarbanes-Oxley Act of 2002. Pub. L. No. 107-204, 116 Stat. 745, 15 U.S.C. §§7201 *et seq.* (July 30, 2002). See, in particular, Title III (Corporate Responsibility).
- H. As *Caremark* made clear, corporate managers and directors can be held individually liable if they fail to adequately inform themselves of relevant facts under which the corporation might be exposed to any of the types of liabilities described above, and thereby allow the company to engage in illegal or improvident activity which results loss or damage.

V. HOW CAN AN EMS HELP BUSINESS MANAGERS IDENTIFY, ASSESS AND MANAGE ENVIRONMENTAL RISKS?

- A. Compliance Assurance. A well-designed and well-implemented EMS should ensure prompt and timely identification of “environmental aspects and impacts,” actual and potential violations of law, and hazardous waste conditions which could involve costs for on-site or off-site cleanup so that the company can take appropriate measures to ensure compliance with applicable law and minimization of associated expenditures.
- B. Information Generation. The auditing and compliance assurance functions under an EMS are designed to provide business managers with prompt information concerning non-compliant situations so that business managers can correct actual or potential violations before they become the subject of enforcement actions.
- C. Risk Identification. A well-designed EMS should include a mechanism to identify activities which are inherently risky in terms of potential environmental, health and safety impacts and associated costs.
- D. Risk Assessment. The effectiveness of the EMS to identify at an early stage potential risk, and to evaluate, assess and mitigate or eliminate that risk, will depend on (1) the comprehensiveness of the EMS, (2) its information flow provisions, and (3) the skills of the people who are responsible for implementing it and ensuring the prompt flow of relevant information to managers.
- E. Using the EMS To Ensure the Efficient Flow of Information. Key elements of the EMS which provide important information to Management concerning potential risks:
 - 1. Audit reports.
 - 2. “Management of Change” analyses. When a new regulation comes out, a process or activity is changed, new chemicals or materials are brought on-site, a new property is about to be acquired, or any other change is contemplated which might bring new or increased risk, the Management of

Change component of the compliance assurance component of a well-designed EMS should trigger an appropriate analysis of the environmental, economic and other impacts of the proposed change. In some instances this may be modest in scope. In others, such as the acquisition of previously used industrial property, the evaluation should include a Phase 1 Site Assessment and a regulatory compliance audit.

3. Top management reviews and corresponding mid-level management reviews.
4. Ranking risk while identifying environmental aspects and impacts. Many companies rank their environmental “aspects” to identify risks, taking into account the likelihood of occurrence and the magnitude of the potential cost or liability if the risk occurs, considered under both a normal operating procedure and a worst case scenario (i.e., what if the controls fail, what if there is a spill or explosion, etc.).
5. The budgeting process for capital and operating costs of environmental controls.
6. Identification and evaluation of actual or pending litigation, pending claims, notices of violation and investigations.
7. Forward looking identification of likely future legislative and regulatory developments. This is relevant to SEC filings, and in particular, the Management’s Discussion and Analysis (“MD&A”), which typically must include forward looking statements for the next two years.

F. This information must be assembled and reviewed by top management on a regular basis.

1. Many companies have compliance assurance officers or ethics committees, or similar bodies.
2. Internal Certification Programs. Some companies require that plants, divisions and other business

units periodically certify that they are in compliance with applicable environmental, health and safety and other laws as well, except as specifically disclosed, at annual or more frequent intervals. A well-designed EMS should be used to providing most, if not all, of the information in this type of internal certification program.

- G. Board of Directors. Management should ensure regular reporting of material risk to the Board of Directors so that appropriate risk management strategies can be developed.

Some boards of directors have an Environmental, Health and Safety Committee, or similar committee whose members have at least some expertise in this field. The committee monitors environmental compliance, risk assessment and management in consultation with senior management and such outside experts as may be necessary. It may also have an oversight role in ensuring that proper reporting and disclosure is made to federal regulatory agencies, including EPA and the SEC.

- H. Agency Reporting: An EMS should include a widely publicized and clearly established mechanism by which any employee reports internally any spill, actual or suspected non-compliance, or other reportable event to his or her supervisor, or on a “hot-line” depending on the nature and urgency of the event, so as to ensure timely response by the company and proper reporting and disclosure to regulatory agencies. This is also important to enable a company to take advantage of EPA’s voluntary disclosure policy, which requires that the disclosure be made within 21 days of when the company comes into possession of facts indicating an actual or apparent violation

VI. RISK MANAGEMENT

- A. Risk Management Resources. Once management becomes aware of an inherently risky condition, a number of options for minimizing or avoiding the risk can be evaluated, including:
1. Changing the way the activity is performed.

2. Provide appropriate training or instructions for performing the activities in question, or addressing the site condition.
 3. Avoiding inherently risky conditions.
 4. Contractual arrangements shifting liability to others. Example: where a contractor is engaged in activities on your property which, if not carried out properly, may subject you to penalties for non-compliance with environmental law or common law liability if toxic or hazardous substances are released.
 5. Commercially available insurance.
- B. Among the most important ingredients for success are competence, training and awareness.
- C. Incentives. A corporate program should reward those who excel in identifying the relevant information and making sure that it gets into the hands of those who are responsible for making the business decisions.
- D. Resources. Business should provide resources necessary to ensure that claims and losses are minimized or avoided, and that any external reporting obligations are promptly and correctly carried out. More broadly, resources must be adequate to ensure performance of the EMS, including the risk identification, assessment and management functions.

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